UK Supreme Court Ruling on FCA Business Interruption Test Case Handed Down

18 January 2021

On 15 January, the UK Supreme Court handed down its judgment in the United Kingdom Financial Conduct Authority's (the "FCA") business interruption insurance test case, following hearings in November 2020 (see here). This test case was described by the FCA in its written statements as "*probably the most important insurance decision of the last decade*". The appeal was in response to the judgment of the High Court handed down on 15 September 2020 (see here).

By way of summary, the appeals of the FCA and the Hiscox Action Group were substantially allowed and those of the insurers were dismissed. However, the Supreme Court's judgment is not a "knockout" for the FCA – there were certain qualifications to the Supreme Court's findings - and insurers and insureds should carefully consider their policy language before reaching an agreement on potential claims. As a result, this may not be the end of actions on this subject. Despite this, the judgment itself appears very insured-friendly, against a backdrop of economic uncertainty caused by the pandemic.

This update briefly summarises the key issues from the Supreme Court's judgment. The three key "classes" of clauses that will be referred to are:

- Disease Clauses: in general, these provide cover for non-damage business interruption losses resulting from the occurrence of a notifiable disease (such as Covid-19) at or within a specific distance of the premises.

- Prevention of Access Clauses: generally speaking, these provide cover for business interruption losses resulting from a public authority's intervention that prevents access to or use of the premises.

- Hybrid Clauses: these are, as the name suggests, generally a combination of the disease and prevention of access clauses that provide cover for business interruption losses after restrictions are imposed, as a result of a notifiable disease occurring within a specific radius of the insured premises.

Disease Clauses

Two of the disease clauses[1] had been decided differently by the High Court to the other disease clauses. The High Court determined that these two policy wordings were intended to be triggered by local-only outbreaks. The FCA asked the Supreme Court to interpret these policies in the same way as the other disease clauses. The Supreme Court did this, but not quite in the way that the FCA may have expected or requested. The Supreme Court found that the High Court had correctly analysed these two disease clauses and, instead, had been wrong in its interpretation of the other disease clauses. It held that the *correct* interpretation is that these clauses cover only cases of Covid-19 that occur at or within a specified radius of the insured premises (typically 25 miles). They are not triggered by cases of Covid-19 that occur outside that geographical area. However, once there is a local case, the Supreme Court held that all cases were an equal cause of the national lockdown (please see "Causation" below).

Actions of a Public Authority

Many of the prevention of access and hybrid clauses required that such prevention of access was the result of "actions" or "restrictions imposed" by a public authority. The High Court had determined that "restrictions imposed" by a public authority would be understood as meaning mandatory measures "imposed" by the authority, pursuant to its statutory or other legal powers. However, the Supreme Court did not accept that the restriction must always have the force of law. It determined that mandatory instructions, given in the anticipation that legally binding measures would follow,[2] would be capable of being "restrictions imposed". Similarly, the Supreme Court found that where compliance is (and is reasonably understood to be) required, without the need to rely on legal powers, such an instruction may amount to a "restriction imposed".[3] This means that earlier statements by the Government before statutory measures were imposed may have triggered the policies.

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1 QBE-2 and QBE-3.

2 Or that such legally binding measures would follow if compliance was not obtained.

3 The Supreme Court did note that this situation is likely to arise only in emergencies (and that the Covid-19 pandemic would be an example of an emergency).

Prevention of Access / Inability to Use

The Supreme Court agreed with the High Court that there must be an "inability to use" the premises – rather than merely an impairment or hindrance. However, the Supreme Court did not accept the High Court's determination that there is no such "inability" where there is the capacity for partial use. The Supreme Court determined that "unable to use" includes the inability to use: (i) the premises for a discrete part of its business activities; or (ii) a discrete part of the premises for its business activities. The Supreme Court came to a similar decision on the term "prevention of access".[4]

Causation

Causation had been a particularly important element of the insurers' appeal and forms a considerable portion of the Supreme Court's judgment.

The insurers had placed considerable weight on the applicability of the "but for" test of causation. While the Supreme Court agreed that in the majority of insurance cases the "but for" test applies, the Supreme Court went on to consider the inadequacies of this test, stating that *"[t]he most conspicuous weakness of the "but for" test is not that it wrongly excludes cases in which there is a causal link, but that it fails to exclude a great many cases in which X would not be regarded as an effective or proximate cause of Y… The main inadequacy, in other words, of the "but for" test is not that it returns false negatives but that it returns a countless number of false positives"*.[5] The Supreme Court then moved on to consider the issue of multiple concurrent causes of loss. It stated that it is well-established that where there are two proximate causes of loss and only one is covered by the policy, the insurer is liable, unless the other cause is specifically excluded, in which case the exclusion will usually prevail. The Supreme Court determined that "*there is nothing in principle or in the concept of causation which precludes an insured peril that in combination with many other similar uninsured events brings about a loss with a sufficient degree of inevitability from being regarded as a cause - indeed as a proximate cause - of the loss, even if the occurrence of the insured peril is neither necessary nor sufficient to bring about the loss by itself*".[6]

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[4] The Supreme Court held that "prevention of access" may include prevention of access to (i) a discrete part of the premises or (ii) to all or part of the premises for the purpose of carrying on a discrete part of the policyholder's business activities.

[5] The Financial Conduct Authority (Appellant) v Arch Insurance (UK) Ltd and others (Respondents) [2021] UKSC 1 at 181.

[6] The Financial Conduct Authority (Appellant) v Arch Insurance (UK) Ltd and others (Respondents) [2021] UKSC 1 at 191.

Following this general statement of law, which in itself may be considered quite a departure from what was considered "settled" insurance law, the Supreme Court turned to the policies at hand – for it is dependent on the language of the policies to determine whether this causal connection is sufficient to trigger the insurer's obligations. In connection with the two classes of clause under consideration, the Supreme Court made the following points:

- Disease Clauses: In connection with the "but for" test, the Supreme Court rejected the insurers' argument that the business interruption loss must have been suffered purely because of the existence of Covid-19 cases within the specified radius on the basis that the same interruption of the business would have occurred anyway as a result of other cases of Covid-19 elsewhere in the country. The Supreme Court determined that it would be sufficient to prove that the interruption was a result of Government action taken in response to cases of disease where there was at least one case of Covid-19 in the relevant geographical area. The Supreme Court agreed with the determination of the High Court that each individual case of Covid-19 that had occurred by the date of any Government action was a *separate and equally* effective cause of such Government action and of the public's response.

- Prevention of Access / Hybrid Clauses: It was determined that business interruption losses are payable only if they result from all the elements of the risk covered in the causal sequence. Using the Hiscox wording, for example, the public authority clause operates to indemnify the policyholder against the risk of all of the elements of the insured peril acting together to cause business interruption loss – this is so even where the loss was concurrently caused by other uninsured but not excluded consequences of the pandemic. Again, the Supreme Court found that the pandemic was the underlying or originating cause of the insured peril.[7]

The Supreme Court determined that the seminal case, the *Orient Express*, had been wrongly decided, and overruled this decision. That case, which the insurers had relied upon heavily in their arguments, previously offered favourable arguments for insurers in relation to the operation of trends clauses (discussed below) and the Supreme Court's ruling may have a lasting impact on future litigation beyond this test case.

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[7] The Supreme Court did note that, had all the elements of the insured peril been present but not been regarded as the sole proximate cause of loss, then there would be no indemnity. For example, a travel agency may have lost all of its business because of the travel restrictions imposed, even though its customers would also not be able to walk in as well. If it was found that the sole proximate cause of the loss of its walk-in customer business was the travel restrictions and not the inability of customers to physically enter the agency, then the loss would not be covered.

Trends Clauses

Trends clauses are part of the "machinery" contained in insurance policies to determine and quantify loss. The Supreme Court made it clear that trends clauses do not, and should not, address or seek to delineate the scope of the indemnity and should always be construed consistently with the operative insuring clauses. Therefore, trends clauses should not be construed such that they take away cover that is otherwise provided under an insuring clause – if that were permitted it would effectively transform the trends clause into another exclusion. The Supreme Court determined that trends clauses do not require losses to be adjusted on the basis that, if the insured peril had not occurred, the business's results would still have been affected by other consequences of the pandemic.

Trends clauses rely on counterfactual scenarios against which the insured's losses are determined:

- Disease Clauses: the Supreme Court held that the correct counterfactual would be the results that would have been achieved by the business during the indemnity period *but for* the pandemic.[8]

- Prevention of Access / Hybrid Clauses: the Supreme Court held that these clauses relied on composite perils (and therefore interconnected elements) and, as a result, the correct counterfactual is the result that would have been achieved *but for* the insured peril and circumstances arising out of the same underlying or originating cause.[9]

In connection with pre-trigger losses, the High Court had decided that the indemnity for business interruption loss that was sustained after cover had been triggered should be reduced to reflect a reduction in the business's turnover as a result of Covid-19, which would have continued even if cover had not been triggered by the insured peril. The Supreme Court rejected this approach. It made clear that in calculating losses sustained, the assumption should be made that pre-trigger losses caused by Covid-19 would not have continued during the operation of the insured peril.

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[8] It was noted that while the Supreme Court had rejected the applicability of the "but for" causation test in the interpretation of the disease clauses (as discussed elsewhere in this update), the "but for" test is expressly called for under the trends clause here.

[9] Despite this, the Supreme Court determined in the previous paragraph that the "but for" counterfactual could not be applied here on the basis that none of the individual elements of the insured peril occurred.

Impact and Influence

In delivering its judgment, the Supreme Court noted that there are some 700 types of policies, written by approximately 60 different insurers in the UK, with an estimated 370,000 policyholders who may be affected by the outcome of the litigation – it is therefore unsurprising that the impact of this case may be felt widely, and it has certainly been of interest to the mainstream media. The Supreme Court will issue a set of declarations in connection with this matter – the parties have been encouraged to agree the appropriate declarations in light of the Court's judgment.

In addition, we expect that this judgment will be persuasive for other common law jurisdictions currently considering non-damage business interruption cases of their own, including certain business interruption cases in the U.S. and Australia – indeed, the Supreme Court judgment referred to case law from the U.S. in connection with its review of the trends clauses.

The ruling is expected to have a considerable influence on the scale of business interruption-related losses in the UK. The FCA has said that it will work with insurers to expedite payments of claims to policyholders.

Similarly, now that the Supreme Court has handed down its judgment, it is expected that reinsurers may face considerable claims from the affected insurers, as the extent of their losses becomes clearer. Following the judgment, certain of the insurers involved have referred to their expected losses "*net of reinsurance*" and confirmed their expectation that "*reinsurance protection is expected to apply*". Despite these statements, certain major reinsurers, including Swiss Re and Munich Re, have publicised a tough stance on excess of loss covers, insisting that in the majority of cases pandemic business interruption is not covered. However, it is generally accepted that proportionate treaties will respond to Covid-19 business interruption claims, written as they are on a "follow the fortunes" basis. While historically these matters may be handled discretely, given the potential size of certain claims, some in the market expect a new wave of litigation as reinsurers and cedants seek clarity on their agreements. In addition, given the approach to causation taken by the Supreme Court, which found that each single case of Covid-19 within the required geographical area, rather than the outbreak of the disease more generally, was an effective trigger of the policy wording (as described above), this may have an impact on how claims are aggregated under reinsurance treaties.

Beyond the financial impact for firms, many industry luminaries, including Bruce Carnegie-Brown, who is the Chairman of Lloyd's, have called for greater simplification and clarity in policy wordings. We have already seen some UK insurers rewrite their

policies to clarify the coverage that the policies are providing, and expect to see greater attention paid to this in the future.

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For more information regarding the legal impacts of the coronavirus, please visit our Coronavirus Resource Center.

Please do not hesitate to contact us with any questions.

LONDON

James C. Scoville
jcscovil@debevoise.com

Clare Swirski
cswirski@debevoise.com

Benjamin Lyon
blyon@debevoise.com

Philip Orange
porange@debevoise.com

Sarah Hale
shale@debevoise.com

Katie Power
kpower@debevoise.com